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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1935

No. 743

FRANK O. LOWDEN, JAMES E. GORMAN and JOSEPH B. FLEMING, as Trustees of the Estate of THE CHICAGO, ROCK ISLAND AND PACIFIC RAILWAY COMPANY,

Appellants Below,

vs.

NORTHWESTERN NATIONAL BANK AND TRUST COMPANY OF MINNEAPOLIS, MINNESOTA, formerly THE NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS, MINNESOTA,

Appellee Below.

ON CERTIFICATE FROM THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

REPLY BRIEF AND ARGUMENT FOR APPELLANTS BELOW

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REPLY BRIEF AND ARGUMENT FOR APPELLANTS BELOW

I.

Appellee's argument that to construe Section 77 so as to preclude the right of set-off under Section 68 would violate the Fifth Amendment. (Page 31.)

The basic argument seems to be this: that to deny the right of set-off in this action will forever preclude

the bank from the benefit of certain equities which it asserts it has. We deny that it has any such equities, but it seems clear that if they do exist, they must be determined and made effective by the plan, and in no other way.

Counsel seek to distinguish the *Continental Bank* case on the theory that it merely precluded creditors from then exercising their remedies, but did not affect their substantive rights, while to deny the right of set-off here would be, not merely to stay the remedy, but to take away a vested right as well. It should, however, be borne in mind that what the bank here asks is, not only that its so-called "vested right" be protected, but that upon the filing of a petition under Section 77, *it be permitted to exercise that right.* In effect, it asks, and the Court below permitted, just what this Court denounced in the *Continental Bank* case, *an immediate foreclosure pending reorganization.*

When this is borne in mind, it is apparent that the bank must do what all other lienholders and claimants must do, await the presentation and confirmation of the plan, and be accorded such rights only as the plan gives it. In other words, the bank's only remedy is to insist that it and all other banks in a like situation be put in a separate class by the Interstate Commerce Commission and the Bankruptcy Court, and that their rights in the property of the debtor, of which the funds in this bank account are a part, be dealt with equitably under the plan. The bank is deprived of no right because, whatever be its rights, it can assert them before the Bankruptcy Court.

To say that because subdivision (j) refers to "property dealt with by the plan" and that if the right of set-off is recognized, the funds from this bank account will not be "dealt with by the plan" (Appellee's Brief, page 20) is to reason in a vicious circle. The same argu-

ment with like force could be made to sustain the right of immediate foreclosure upon a first lien on a railroad's main line. As we have repeatedly pointed out, what property is to be dealt with by the plan is to be determined by the Interstate Commerce Commission and the Court, with full right to all creditors and lienholders to be heard, and not by each individual creditor acting for himself. But in the meantime, all properties of the debtor are within the exclusive jurisdiction of the Bankruptcy Court.

But aside from all this, the argument falls of its own weight, because it assumes that at the date of the passage of the act (March 3, 1933), the bank had a vested right of set-off. The reverse is true. At the moment Section 77 became effective, the bonds were not due, and the railway was neither insolvent nor unable to meet its debts as they matured.[1] There was no reorganization petition filed, contemplated, or (until after the act was passed) possible. Therefore, when the act became effective there existed no right of set-off either in law or in equity under any theory. Of course, in addition to all this, Section 68 at that time had no application, because the Bankruptcy Act did not apply to railroads. If Section 77 and the proceedings under it be eliminated, no possible right of set-off then existed on any theory.

On pages 29 and 30, counsel refer to subdivision (g), quoting part of the language to the effect that the plan shall provide

> "adequate protection for the realization by them of the value of their securities, liens and claims."

It is true that this subdivision contains such language, but counsel's reference to it is misleading in that there

[1] Even after the passage of Section 77, the railway continued to pay its debts as they became due. On June 7, 1933, there was no default "in the payment of either principal or interest" of its bonds (R. 2). The April 1, 1933, interest must have been met, as well as the interest due October 1, 1932. The findings of the trial Court show this definitely (11 Fed. Supp. 929 (931-Column 2)).

is a failure to quote the language immediately preceding, which expressly states that it applies only to creditors "who would not become bound by the plan."

As originally pointed out, if the bank has any such equities, which require recognition, they will be protected by the plan.

II.

Appellee's argument that "insolvency," within the rule that the debtor must be insolvent in order to accelerate its debts, means mere inability to meet debts as they mature. (Page 42.)

It perhaps may not be necessary to determine what the meaning of the word "insolvency" within this rule is generally, since it seems entirely clear that the Congress by the passage of Section 77 never intended that a solvent railway's bonded indebtedness should become immediately due upon the filing of a petition. If it did not intend to preclude all set-offs, it certainly did not intend to place a solvent railway in a worse position than it was before, and to provide that upon a solvent railway's taking advantage of Section 77, all debts became immediately capable of enforcement, which otherwise would not have been enforceable for many years to come.

Counsel brushes aside any argument based on the intention and purpose of Congress with the statement that such purpose is unimportant. The proposition is stated thus (page 24):

> "Parties to a contract, or legislative bodies, may have a purpose, even clearly beyond dispute, but they may omit to make actual provisions necessary to give effect thereto."

This overlooks the familiar rule that the intent and purpose of the legislative body is the important factor in the construction of a statute. This Court expressed the idea in the *Continental Bank* case, saying:

> "And to prevent the attainment of that object is to defeat the very end, the accomplishment of which was the sole aim of the section, and thereby to render its provisions futile."

In fact, a Court may and should construe an act in the face of the strict letter of the law when necessary to accomplish what Congress intended.

Church of Holy Trinity v. *United States,* 143 U. S. 457.

Fleischmann Construction Company v. *United States,* 270 U. S. 349.

However, it is clear that the word "insolvency," as used in the rule that insolvency accelerates debts, means actual excess of liabilities over assets.

"Insolvency" has, of course, a variety of meanings, depending upon the phase of the law under consideration. It may have different meanings in different statutes, and a different meaning from either in common parlance, all depending on the circumstances.[2]

Not one of the cases cited by the bank has the slightest application to the question here.

Steele v. *Randall,* 19 Fed. (2d) 40 (8th Circuit), and *Federal Reserve Bank* v. *Idaho Grimm Alfalfa Seed Growers' Association,* 8 Fed. (2d) 922 (9th Circuit), had to do with the question of insolvency of national banks under the National Banking Act, 11 U. S. C. 91. There is no doubt that the word "insolvent," *as used in the Banking Act,* means inability to meet its debts as they

[2] See 30 Michigan Law Review, 1040, "When is a corporation insolvent?" and 14(a) C. J. Section 3058.

mature. (*Federal Intermediate Credit Bank* v. *L'Herisson,* 33 Fed. (2d) 841 (8th Circuit); *Aycock* v. *Bradbury,* 77 Fed. (2d) 14 (10th Circuit). Compare *United States* v. *Oklahoma,* 261 U. S. 253.)

In neither case was there a distinction made between actual insolvency and inability to meet current debts. In the *Steele* case actual insolvency seems to have been conceded, the only question being the time when this occurred, and the *Idaho Association* case was disposed of by a determination by the Court that the evidence supported a finding that the bank was "insolvent, if indeed it was not wholly and hopelessly so."

It, of course, ought to be the law, as it is, that a national bank is insolvent "when it cannot pay its depositors on demand in accordance with its promise."

In recognition of this, there has always been a distinction between what constitutes insolvency on the part of a banker, trader, or merchant and those engaged in other lines. As to the former, insolvency usually means mere inability to meet its debts as they mature. As to the latter, it means excess of liabilities over assets.

Toof v. *Martin,* 13 Wall. 40.
Wager v. *Hall,* 16 Wall. 584 (599).
Steele v. *Allen,* 240 Mass. 394; 134 N. E. 401.
Williamson v. *Hatch,* 55 Minn. 344; 57 N. W. 56.
Daniels v. *Palmer,* 35 Minn. 347; 29 N. W. 162.
Crenshaw v. *Halvorsen,* 183 Ia. 148; 165 N. W. 360.

The latter is "its general and popular meaning." *Toof* v. *Martin, supra*; *Ratcliff* v. *Clendenin,* 232 Fed. 61 (8th Circuit); *Crenshaw* v. *Halvorsen, supra*; *Frank* v. *Stearns,* 111 Neb. 101; 195 N. W. 949.

The other cases cited by appellee merely enunciate the familiar rule that inability to meet debts as they

mature may be, in connection with other matters, ground for the appointment of a receiver in equity. So far as we know, this has never been questioned. Most equity receiverships exist because the debtor is not insolvent but only financially embarrassed.

On page 46, counsel argue that the bonds should be regarded as having matured, because in its petition the railway announced its inability "to meet its debts as they mature." In other words, it is sought to invoke the rule of "anticipatory breach of contract." It is a sufficient answer to this suggestion to call attention to the fact that whatever may be the extent of the application of this rule to contracts generally, it does not apply to a mere unilateral contract to pay money.

> "In the case of an ordinary money contract, such as a promissory note, or a bond, the consideration has passed; there are no mutual obligations; and cases of that sort do not fall within the reason of the rule."
>
> *Roehm* v. *Horst,* 178 U. S. 1 (17).

III.

Appellee's argument that because the bonds matured by their terms before the trial, the right of set-off should be recognized. (Page 47.)

The argument that it is the duty of the Court to deal with the situation as it existed at the time of trial, even if it is sound, does not help the bank in the least. If it be conceded that because the bonds were not then due no right of set-off existed on June 7, 1933, then from that time the bank was wrongfully withholding funds, no longer belonging to the railway, but belonging to these trustees. If, then, the bank is permitted on and after April 1, 1934, when the bonds came due, to set them off against the funds so withheld by it, it would

amount to the Court's countenancing a set-off of obligations of the railway against funds of the trustees under the control of the Court. Merely to state the argument is to refute it. The obstacle to the application of the rule for which the bank contends lies in the fact that after June 7, 1933, and at the time of trial, the bank owed the railway nothing, but its indebtedness was to the trustees. It is the time of filing the petition which determines the right of set-off.

McDaniel National Bank v. *Bridwell,* 74 Fed. (2d) 331 (8th Circuit).

Corn Exchange National Bank v. *Locher,* 151 Fed. 764 (3rd Circuit).

However, it would hardly seem that this question arises upon any of the questions certified.

IV.

Appellee's argument that under the old Bankruptcy Law a person may go through voluntary bankruptcy even though solvent. (Page 38.)

Section 3 of the Bankruptcy Act (11 U. S. C. 21), defining acts of bankruptcy, reads as follows:

> "(a) Acts of bankruptcy by a person shall consist of his having (1) conveyed, transferred, concealed, or removed, or permitted to be concealed or removed, any part of his property with intent to hinder, delay, or defraud his creditors, or any of them; or (2) transferred, while insolvent, any portion of his property to one or more of his creditors with intent to prefer such creditors over his other creditors; or (3) suffered or permitted, while insolvent, any creditor to obtain a preference through legal proceedings, and not having at least five days before a sale or final disposition of any property affected by such preference vacated or dis-

> charged such preference; or (4) made a general assignment for the benefit of his creditors, or, being insolvent, applied for a receiver or trustee for his property or because of insolvency a receiver or trustee has been put in charge of his property under the laws of a State, of a Territory, or of the United States; or (5) admitted in writing his inability to pay his debts and his willingness to be adjudged a bankrupt on that ground."

It is, therefore, clear that except in cases falling within Section 3 (a), (4), relating to assignments for the benefit of creditors (*West Company* v. *Lea*, 174 U. S. 590), the act was clearly intended to apply only to those creditors who were actually insolvent. Even in such a case, there must in reality be insolvency on the part of the debtor, because by the assignment he has divested himself of all his property, although before he made the assignment he may not have been actually insolvent. While it is, of course, true that neither Section 3 (a), (1), nor Section 3 (a), (5), uses the word "insolvent," they describe a situation within the definition of insolvency contained in Section 1, (15), of the Bankruptcy Act. (See page 23, Appellants' original brief.) As already indicated, Section 3 (a), (5), provides that an act of bankruptcy consists in having "admitted in writing his *inability to pay his debts* and his willingness to be adjudged a bankrupt on that ground."

Form No. 1 (debtor's petition), prescribed by the general bankruptcy orders of this Court (172 U. S. 653), requires that a voluntary bankrupt must allege "that he owes debts *which he is unable to pay in full.*" (172 U. S. 667.)

The meaning of the words "*inability to pay* his debts" and "debts which he is *unable to pay in full*" is clear. Contrast them with the words used in Section 77 "unable to meet its debts as they mature." The former

means insolvency. This Court specifically so held in *Cunningham* v. *Norton,* 125 U. S. 77, where it said with respect to substantially the same words used in an assignment for the benefit of creditors:

> "When a person is unable to pay his debts, he is understood to be insolvent. It is difficult to give a more accurate definition of insolvency."

The latter means "one who although unable to pay promptly may be able to pay if time to do so be sufficiently extended." (*Continental Bank* case.)

It is inconceivable that there could be an adjudication in bankruptcy under a voluntary petition which alleged that the debtor was perfectly solvent and perfectly able to pay his debts.

Therefore, the reason (*i.e.,* insolvency) for allowing the set-off of an unmatured claim in a bankruptcy proper is entirely absent here, because there is no insolvency.

V.

Appellee's discussion of Question 3 (Page 50.)

Most of appellee's discussion of Question 3 is devoted to "the extent of, and limitations upon the jurisdiction of the bankruptcy court under the general provisions of the Bankruptcy Act." This is interesting, but academic here. In any event the conclusions drawn by appellee are not in accord with the decisions of this Court. A very good statement of the law, as it is established by recent decisions of this Court, is found in *Taylor* v. *Sternberg* (1935), 293 U. S. 470, 79 L. ed. 599, where the Court said:

> "Upon adjudication in bankruptcy, all the property of the bankrupt vests in the trustee as of the date of the filing of the petition. Upon such filing,

> the jurisdiction of the bankruptcy court becomes paramount and exclusive; and *thereafter that court's possession and control of the estate cannot be affected by proceedings in other courts, whether state or federal. Gross* v. *Irving Trust Co.,* 289 U. S. 342, 344, 77 L. ed. 1243, 1244, 53 S. Ct. 605, 90 A. L. R. 1215, 22 Am. Bankr. Rep. (N. S.) 661; *Acme Harvester Co.* v. *Beekman Lumber Co.,* 222 U. S. 300, 307, 56 L. ed. 208, 213, 32 S. Ct. 96, 27 Am. Bankr. Rep. 262; *Re Diamond* (C. C. A. 6th) 259 F. 70, 73, 44 Am. Bankr. Rep. 278. This applies while the possession is constructive as well as when it becomes actual. *Mueller* v. *Nugent,* 184 U. S. 1, 14, 46 L. ed. 405, 411, 22 S. Ct. 269, 7 Am. Bankr. Rep. 224; *Taubel-Scott-Kitzmiller Co.* v. *Fox,* 264 U. S. 426, 432, 433, 68 L. ed. 770, 773, 774, 44 S. Ct. 396, 2 Am. Bankr. Rep. (N. S.) 912; *Orinoco Iron Co.* v. *Metzel* (C. C. A. 6th) 230 F. 40, 44, 45; and cases cited." (Italics supplied.)

Nor have we erroneously construed the *Cumberland Glass* case, as contended by appellee. We cited that case to call the attention of the Court to the emphasis placed by the Court upon the words in Section 68(a) "the account shall be stated." The fact that the Court referred in its opinion to cases in the state courts permitting a set-off in plenary actions is not material; because the question here involved does not appear to have been raised in those cases. For instance, *Wasey* v. *Whitcomb,* 167 Mich. 58, 132 N. W. 572, involved essentially only the actual amount due by the defendant to the bankrupt, on a contract to finance the sale of pianos. *Wagner* v. *Burnham,* 224 Pa. 586, 73 Atl. 990, was a suit by the trustee of a bankrupt building contractor to recover the amount due on a building contract. The Court merely held that from the amount due must be deducted the amount required to discharge subcontractors' liens. The question of forum was not involved.

In any event the law, as it stands, even under the old Act, is stated in *Isaacs* v. *Hobbs Tie & Timber Co.*, 282 U. S. 734, where this Court said:

> "Thus, while valid liens existing at the time of the commencement of a bankruptcy proceeding are preserved, *it is solely within the power of a court of bankruptcy to ascertain their validity and amount and to decree the method of their liquidation.*" (Italics supplied.)

When we come to consider the procedure under Section 77, however, the situation is clear beyond dispute; because that section, both as originally passed and as amended in 1935, conferred upon the Bankruptcy Court *exclusive jurisdiction* of the debtor and its property wherever located. Even before the 1935 amendment this Court had held that the process of the Bankruptcy Court in the exercise of the powers conferred by Section 77 might run beyond its immediate territorial jurisdiction (*Ex Parte Baldwin,* 291 U. S. 610). The construction contended for by appellee would eliminate the word "exclusive" from the statute.

Appellee cites the case of *In re Prudence-Bonds Corporation,* (C. C. A. 2nd) 75 F. (2d) 262, as authority for the proposition that Congress did not intend the Bankruptcy Court, in proceedings under Section 77B, to take over all litigation between the debtor and third parties (Appellee's Brief, page 64). That citation disposes of the point made by appellee that the trustees in bankruptcy here should not be heard to deny the jurisdiction of the Minnesota court which they have voluntarily invoked. The trustees are not denying that jurisdiction. They are merely asking the aid of the Minnesota court (as sanctioned in the *Prudence-Bonds* case cited by appellee) to compel the bank to turn over to the trust estate property in its possession. All that they are denying is the right of the bank to assert in the Minnesota

court a claim to set-off. The trustees deny this right because Section 77 makes the Bankruptcy Court the exclusive forum for the determination of that question.

If authority were needed in addition to that already cited, a complete and clear exposition of the matter is found in a subsequent decision of the Circuit Court of Appeals for the Second Circuit in the same *Prudence-Bonds* proceeding. Another phase of that case reached the Circuit Court of Appeals on the question of an injunction to restrain trustees of mortgages made by the bankrupt from disposing of the collateral securing those mortgages, this collateral consisting of large numbers of real estate mortgages. See *In re Prudence-Bonds Corporation,* (C. C. A. 2nd, 1935) 77 F. (2d) 328, certiorari denied by this Court October 14, 1935. Although we do not wish to weary the Court with citations, we quote particularly the following language which illustrates clearly the point we have in mind:

> "Formerly, the court, while having jurisdiction of whatever equity a bankrupt might own in pledged property, did not have jurisdiction over the property itself. The property was in the possession of the pledgee, and the bankrupt having neither real nor constructive possession thereof, the bankruptcy court had no jurisdiction over it. *Taubel, etc., Co.* v. *Fox,* 264 U. S. 426, 44 S. Ct. 396, 68 L. Ed. 770. But the present grant of jurisdiction, under section 77B, contains no limitation which excludes property subject to a lien or mortgage.
>
> * * * * *
>
> "The court of reorganization can bring within its jurisdiction property covered by mortgage or pledge, when a plan covering it has been adopted and confirmed. And prior thereto, property held by a pledgee, in which the debtor has an equity, is likewise within the court's jurisdiction, so as to prevent a disposition by foreclosure of the pledge or mortgage. For the purpose of reorganization,

the court should take complete charge of property in order that it may from the beginning, and through all the intermediate steps of reorganization, so administer the property as to achieve the desired rehabilitation."

Respectfully submitted,

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